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EBF response to the Commission consultation on Covered Bonds

EBF position / response

PART I: COVERED BOND MARKETS: ECONOMIC ANALYSIS

QUESTIONS - COVERED BOND MARKETS: ECONOMIC ANALYSIS

1. In your opinion, did pricing conditions in European covered bond markets converge and diverge before and after 2007, respectively? If so, what were the key drivers of this convergence/divergence? Please, provide evidence to support your view.

The EBF believes that there was a clear divergence as evidenced by secondary market spreads for peripheral bonds before and after the crisis.

Key drivers are highlighted in our response to Q2.

There clearly was divergence within secondary market after 2007 as indicated by the increased yield dispersion between different member states. However, the spreads are narrow these days. The legislation behind each member states' covered bond market is rather similar which only demonstrates that investors have been making their decisions based on sovereign economic situations.

2. Was pricing divergence an evidence of fragmentation between covered bonds from different Member States? Do you agree with the reasons for market fragmentation described in section 2.1 of Part I? Were there any other reasons?

The primary reasons for the divergence relates to the first 2 points in section 2.1, Part I i.e. the risk assessment of the cover pool/credit rating of the issuer and the sovereign. Therefore, EBF is of the opinion that the main reasons for the dispersion between Covered Bonds of various Member States after 2007 are not to be found in different legal frameworks.

The impact of a fragmented covered bonds market is only likely to result in material pricing divergence in a much stressed environment when bondholder protection (indexation of cover pool, supervision, minimum over-collateralisation etc.) becomes an increasing focus for investors – typically distressed fund/high yield investors. While the EBF supports the concept of harmonisation in general it is unlikely to have a measurable impact on pricing convergence/divergence given that the market is currently functioning efficiently.

Legislation is already rather similar in member states and the market is also functioning well in sovereigns. The benefit of harmonisation would be fairly negligible because of the basics of market behaviour. In times of market turbulence certain investors look for safe havens. Trying to achieve pricing convergence in times of

stress through harmonisation of covered bond legislation might not affect investor behaviour. This is because of the already quite similar legislation in member states and investors' perception of certain countries' abilities to solve tensions in their economy. Even with full harmonisation it could be difficult to entirely assure investors of similar institutional and legal settings in different member states. Therefore, while harmonisation has justifiable premises, the debate can have fallacies if investors cannot be convinced of similar legal framework.

3. In your view, is there any evidence of pricing differentiation/fragmentation between covered bond issuers on the basis of size and systemic importance, as well as their geographical location?

The EBF believes some evidence in this regard could be provided by rating agencies within their covered bond framework analysis

Furthermore, within most jurisdictions there could be pricing differentials between large / 'national champion' issuers and smaller / 'second tier' issuers. This pricing differential cannot be just accounted for by rating differentials alone. Certain jurisdictions which represent a significant percentage of covered bond issuance could be seen as having a pricing advantage over smaller jurisdictions which may be seen as less important in the overall European context.

Additionally we also note there seems to have developed price preference for a large CBs eligible for the LCR.

4. Is there an appropriate alignment in the regulatory treatment between covered bonds and other collateralised instruments? If there is a misalignment, could you illustrate what differences in regulatory treatment you deem as inappropriate and why?

Yes. Covered bonds enjoy "preferential" treatment because of a number of characteristics that are unique to this asset class. These characteristics include a long established history (over 200 years), excellent performance (zero defaults), special public supervision and the dual recourse nature of the instrument that is backed by legislation.

The EBA reiterates the appropriateness of the risk weight treatment of covered bonds based on historical performance and the structure of the product and that view is supported.

The appropriate treatment can be seen in contrast to the treatment of securitisation from liquidity and capital perspectives which contain harsh disincentives the details of which have already been outlined in other European analyses of the securitisation market post crisis.

As a low risk instrument with good historical performance and dual recourse principle, covered bonds certainly have preferential regulatory treatment over other collateralised instruments such as ABS's. One of the reasons is that for example for securitisation in certain countries there may not be clear regulation. Therefore, CMU's creation of STS-standard for securitisation is certainly recommended.

5. Are operational costs for covered bond issuance lower than for other collateralised instruments? Can you quantify the respective costs, even if only approximately?

There are significant upfront and on-going costs to the establishment and running of a covered bond programme.

Whether the issuance of a covered bond is more efficient than other collateralised instruments will depend on (i) the structure of the covered bond issuer (ii) the volume of issuance.

Ongoing operational costs of issue are thereafter significantly lower than securitisations which tend to have high 'per transaction' operating costs.



6. Are there significant legal or practical obstacles to:

a) cross-border investment in covered bond markets within the Union and in third countries?; and

b) issuance of covered bonds on the back of multi-jurisdictional cover pools?

(a) The EBF is not aware, to the best of our knowledge, of significant legal or practical obstacles within the EU. However bonds issued from non-EEA jurisdictions are subject to different regulatory rules e.g. LCR, ECB repo eligibility which investors will take into account when considering investment opportunities.

(b) There are numerous examples of the issuance of covered bonds versus pools of assets in multiple jurisdictions. Covered bond issuers from a number of Member States are able to place covered bonds backed by multi-jurisdictional cover pools and it is up to the national covered bond legislation to allow for multi-jurisdictional cover pools.

At the same time, there are a number of difficulties when issuing multi-jurisdictional covered bonds: legal peculiarities in each jurisdiction – e.g. in terms of asset segregation, constitution of guarantees or potential problems related to fiscal or operational issues for assets, such as different IT systems.

In addition, the transfer of the cover assets to the cover pool must be legally sound. In cases of multi-jurisdictional assets the legal soundness needs to be assessed for all jurisdictions involved and must be backed by legal opinions. This legal soundness amounts to transferability of the loans, perfection of the transfer, recognition of an effective transfer, perfection of any security, recognition of effective security, availability of all security rights on the mortgaged/secured assets for the pool as transferee etc. The complexity involved might prevent issuers from including multi-jurisdictional assets and investors from investing in such covered bonds, especially if they have to conduct a detailed due diligence into the cover assets. For such due diligence investors also would have to look into all national asset markets involved.

For instance the market-led Covered Bond Label Initiative enhanced significantly the level of transparency by implementing the Harmonised Transparency Template. The latter provides detailed information, amongst other, on geographical exposure of the cover pool facilitating the investor's due diligence when it comes to multi-jurisdictional cover pools.

PART II: EXPLORING THE CASE FOR A MORE INTEGRATED FRAMEWORK

QUESTIONS – LEGAL FRAMEWORK AND INTEGRATION

1. Would a more integrated "EU covered bond framework" based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

- In principle the EBF believes it should deliver those benefits. All benefits stem from having a wider and deeper market of issuers and investors of a debt instrument governed by legislation based on key commonly agreed principles and commonly agreed market practices (e.g., reporting, transparency). This is important and relevant to set up a level playing field for issuers all over Europe, allowing prices to be formed solely on credit risk as opposed to on any sort of prejudices concerning a particular jurisdiction. This would benefit all EU member states, allowing diversification for investors and participation of issuers of smaller jurisdictions in a wider market. For the latter, this might result in added costs - in producing information and data, adapting IT systems, allocating more staff to serving and reporting – and can therefore be seen as a "disadvantage". Still, we believe that, on the whole, it would be beneficial.
- A future set up should also be able to accommodate specialized covered bond issuers (specialized mortgage banks that do not receive deposits). Such mortgage banks may only fund the lending by issuing covered bonds (match funding).



- Concerning the benefits outlined in section 2 of Part II, we consider that the goals of reduced costs via simplified legal due diligence and enhanced transparency, in particular would be furthered by a more integrated EU covered bond framework. Initiatives such as the Covered Bond Label (CBL) and the Harmonised Transparency Template (HTT) are an effective and collaborative mechanism through which greater harmonisation and its attendant benefits can be achieved. However, familiarity with legal framework is perhaps a less significant factor in EU investor/EU issuer investment decisions than in third country investor/EU issuer investment decisions and as such the effect of harmonisation may be somewhat limited in reducing home bias as between EU Member States. It can be argued that the market fragmentation which took place during the crisis was not that peripheral covered bonds suffered stigmatisation due to weaknesses in legal frameworks rather than the product of the other reasons put forward in the consultation and in the economic analysis discussion above (scale of local mortgage market downturns, covered bonds perceived as a proxy for sovereign risk, rating agency actions).
- The possibility of mitigating or eliminating the reliance on external ratings is a laudable goal but may be difficult given the existing reliance on external rating for key regulatory treatment of covered bonds (LCR, Risk Weights, ECB repo eligibility). In addition the vast majority of investment guidelines, to which funds operate, require external rating.
- Additionally, a single integrated EU legislative framework for covered bonds may conflict with national legislative frameworks in relation to insolvency rules, property etc. An approach (Option 1) based on harmonising national frameworks around a common set of standards, where, feasible should be the preferred approach. A more integrated “EU covered bond framework” structured in a balanced way could be beneficial for both issuers and investors. It is important to identify the specific areas in which any such harmonization can take place, also considering the difference existing in term of structures and models. Indeed, a certain number of areas (such as those indicated by the EBA) can be the object of a new harmonisation effort of the Commission and they would promote market integration without hurting the best practices adopted across the various jurisdictions.
- A more integrated covered bond framework would reduce the work-load for risk managements, also for central banks regarding covered bonds as collateral. However, even under a more harmonised framework, there could still be significant differences regarding bank credit quality, cover pool credit quality, underlying mortgage markets, banking system and sovereign quality, ultimately leading to differences of covered bond credit quality.
- A truly integrated “EU covered bond framework” will be very difficult to achieve in light of very different mortgage markets and insolvency rules across the EU.

2. In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?

The Covered Bond Label initiative concerns one aspect that any integration effort should consider: transparency and homogeneity of reporting. To that extent, it contributes to better integrate covered bond markets. Furthermore, an obvious benefit of utilising market initiatives such as the CBL to achieve harmonisation is the ability of such initiatives to adapt and react rapidly to address market developments without the requirement for lengthy legislative process. To the extent that complementary legislative measures are required for other aspects, an approach that facilitates harmonisation of existing frameworks, thereby minimising disruption to existing programmes and markets, rather than a more ambitious integration approach should be adopted.

However some EBF members believe that the legal aspects need to be addressed before we can have a fully integrated European-wide covered bond market. Additionally a fully harmonised EU framework for covered bonds would require an alignment of a number of underlying factors such as insolvency rules, socioeconomic factors and property market performance which are difficult to achieve and falls outside the scope of covered bond regulation.



3. Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration? If so, which of the options suggested in section 3 of Part II should the Commission follow to that end and why?

EBF members consider that a policy of legal/regulatory convergence would best be achieved via Option 1 (subsidiarity and indirect harmonisation). The EU covered bond market is comprised of established, well-regarded domestic legislative frameworks. Investors have developed a knowledge bank in these frameworks by a long course of dealing. Any harmonisation scheme must factor in significant project of investor re-education in order to maintain the existing levels of investor knowledge and comfort as gaps in investor knowledge or uncertainty surrounding a new framework, in particular as to insolvency laws, would likely adversely affect covered bond investment. Preservation of domestic frameworks insofar as permitted by harmonisation aims should therefore be a joint goal of the harmonisation project. For this reason, we consider that the principles-based approach in Option 1 is optimal.

Option 1 has the additional benefit of being capable of introduction without legislative measures (it could be incorporated via the CBL as outlined above) which would facilitate harmonisation in the timeliest fashion of the options proposed.

At a later stage, option 2 could also be pursued. In this respect, we think that the best instrument would be a directive, which could ensure – as indicated in the consultation document – a flexible approach by combining detailed requirements in some areas (such as the areas identified by EBA) with high level principles in others (such as the aspects covered by the national legislation).

4. Specifically, if the Commission were to issue a recommendation to Member States as suggested in section 3 of Part II would you consider that sufficient or should it be complemented by other measures (both legislative and non-legislative)? (see question 8 below)

A recommendation to Member States would appear to be the most appropriate method of implementing Option 1. This would facilitate timely implementation and minimize risk of unintended consequences, particularly in relation to insolvency laws. In the long term, the indications contained in the non-legislative instrument could be included in a directive in order to ensure full convergence on certain key aspects.

For instance, investors would draw enough comfort from a harmonized EU-wide covered bond market based on EBA's recommendations of best practices. We see legal requirements as potentially counterproductive at this stage.

Nevertheless, we believe that certain European rules could be revised, at least in the following fields: i) changes to CRR and other solvency legislation to provide for a preferential treatment of Covered bonds that comply with the recommendations and ii) changes to BRRD could be necessary to address Covered Bonds issues beyond the bail-in tool.

5. On the suggested list of high level elements for an EU covered bond framework:

a) is the list sufficiently comprehensive or should it include any other items?

b) should the Commission seek to develop all the elements or a subset of them?

c) if only a subset, should the Commission give priority to the target areas identified by the EBA Report: (i) special public supervision of cover pools and issuers; (ii) characteristics of the cover pool; and (iii) transparency?

(b) We believe that most of the elements are appropriate at this stage. However, we note that certain elements should be developed further into more concrete, clear and consistent terms. For example convergence on ALM.
(c) Yes.



6. What are your views on the merits described under section 3 of Part II of using different legal instruments to develop an EU covered bond framework? In particular, would it be desirable to harmonise through a directive some of the legal features of covered bonds and requirements applicable to them under Member States' laws? If it were proposed, how could a 29th Regime on covered bonds be designed to provide an attractive alternative to existing national laws?

As indicated above, a combination of non-legislative instrument and, in the longer term if necessary, of a directive could be a solution that would ensure harmonization without unwanted disruptive consequences on the market.

Compared with the establishment of a so-called "29th regime" and the market introduction of a new unified product at the European level with a separate legal framework, the EBF believes that minimum harmonisation offers more advantages (e.g. risk diversification).

Traditional covered bonds have ensured financial stability and access to capital markets during the crisis thanks to very precise macro-prudential characteristics. Any tightening of these qualitative characteristics on national levels could jeopardise the systemic importance of this asset class

7. How should an EU covered bond framework deal with legacy transactions?

In our view, there is no reason to treat "legacy transactions" any worse than covered bonds under a potential EU covered bond framework.

Legacy transactions should be grandfathered to maturity. However, an approach based on Option 1 (subsidiarity and indirect harmonisation) should be sufficient and pose less of a risk to established programmes and frameworks in yielding the benefits of more common standards. We would like to stress that the introduction of any new framework must be accompanied by a longer grandfathering program, as some covered bonds can have a particularly long time to maturity. If this is not properly accommodated, the introduction of the framework could be damaging to national markets and economies.

8. Would you view a combination of recommendations to Member States (Option 1) and targeted harmonisation of certain minimum standards (Option 2) as desirable and sufficiently flexible? If so, what should be the subject of each option?

As mentioned already EBF members are generally in favour of further convergence through option 1, i.e. an indirect harmonisation through a recommendation addressed to Member States.

However, we are supportive of combining the proposed option 1 and option 2, thus allowing some flexibility and diversity, which is critical, and also introducing certain legislative measures to set minimum standards in order to better protect the covered bond market.

We would also like to underline that the EBA already identified in its report what they considered to be the most important areas in ensuring the establishment of a robust covered bond framework, and identified the principles of best practise in each area based on the currently existing covered bond national framework in the EU.

PART III: ELEMENTS FOR AN INTEGRATED COVERED BOND FRAMEWORK

QUESTION – COVERED BOND DEFINITION

What are your views on the proposals set out in section 1 of Part III for a "new legal definition" of covered bonds to replace Article 52(4) of the UCITS Directive?



Overall the EBF supports the Commission proposal of strengthening the covered bond definition, thus replacing the current definition set out in the UCITS directive. Extension of the definition of “covered bonds” to bonds issued by third country issuers would be most appropriately achieved via Option 1. However, we would not support this extension for the following reasons:

(i) Recognition of third country covered bonds could lead to dilution of the EU covered bond product as covered bonds of such third countries, even where comparable to EU covered bonds under a range of high-level headings, will invariably incorporate domestic characteristics different to those of EU Member States. This would necessarily have the effect of complicating the definition of covered bonds, which is at odds with the goal of simplifying the framework as a whole.

(ii) Third country issuers are not subject to the same regulatory standards as EU Member State issuers and in particular, SSM-regulated issuers. These standards may fall short of those imposed on EU Member State issuers. Extension of the covered bond hallmark to third country issuers on this basis may undermine the asset class as a whole and create an uneven playing field as between EU Member State issuers and third country issuers.

We have otherwise no objection to the broad terms of the proposed definition as outlined and we would welcome further detail as to the “other applicable requirements” forming part of the definition for consideration. In particular, any proposal for a certification procedure should be assessed with care in order to avoid additional administrative costs and delays in the issuance of covered bonds. If further harmonisation is achieved through the incorporation of recommendations into the national legal systems, national regulators/supervisors will be the best suited to judge if national instruments comply with those recommendations, under EBA/ESMA monitoring and/or peer reviews.

QUESTIONS – ISSUER MODELS AND LICENSING REQUIREMENTS. ROLES OF SPVs

1. Should the current licensing system be simplified to require a "one-off" authorisation only for all covered bond issuers based on common high level standards? What specific prudential requirements (that is, in addition to those in CRR and CRD) could be applied as a condition for granting a covered bond issuer license?

- If a bank satisfies the prudential requirements set forth under the CRR/CRD rules (and complies with the MREL limit), it should be allowed to issue covered bonds without the need for an additional capital requirement conditions.
- Certain national frameworks provide for a minimum level of own funds, total capital ratio and CET 1 in order for a bank to be allowed to issue and segregate assets in favour of the bondholders. Any limit should take into consideration these national regulations in order to be acceptable in terms of protection for the depositors.
- We support the provision of conditions similar to the rules set off in Member States where such provisions are already in place. Nevertheless, we bode the capital requirement to be set at a level that would allow small banks to issue covered bonds too.
- The legal/regulatory covered bond framework should provide that, at establishment of a given covered bond programme, a cover pool monitor can be appointed, as an alternative for the supervisory authority being vested with the monitoring responsibility. The framework should provide for the eligibility criteria for the appointment and the cover pool monitor’s main duties and powers including, but not limited to, the monitoring of all coverage requirements and eligibility tests and the random auditing of the cover pool. The independent monitor should be appointed by, and report to the National Financial Supervisory Authority.



- The cover pool monitor, where applicable, and/or the issuer, based on the findings of the cover pool monitor, should regularly report to the competent authority.
- A covered bond programme shall be considered to have been established when a cover pool is established for the inaugural covered bond issue. Within the same covered bond programme additional collateral may be subsequently added to the cover pool and further covered bonds may be issued granting investors claims which rank pari passu with the claims attached to the existing bonds collateralised by the same cover pool, in the event of issuer's insolvency.
- We do not see a reason why the EC would need to stipulate in detail a standardised set of license requirements. While more homogeneous license requirements would have the benefit that investors could easier find out what issuer actually needed to fulfil to be granted a covered bond license, it probably makes sense to reduce license requirements in countries that demands more than other countries so far. Hence, general minimum requirements regarding a covered bond license would probably be a good point to start with. For example, besides fulfilling legal requirement for covered bonds, showing a business plan for covered bonds, i.e. clarifying that covered bond issuance is not only a one-off event could be part of a license requirement. In countries allowing a bank to have more than one covered bond programme, it would make sense that every programme needs a license.

2. If the covered bond issuer is subject to a one-off covered bond-specific licence, what would be the additional benefits of requiring that each covered bond programme be subject to prior authorisation as well? Alternatively, would pre or post notification to the competent authority of the programme and of each issue within or amendment to the programme suffice? How should "covered bond programme" be defined for these purposes?

All the issuers are already heavily regulated entities. They are supervised either by the SSM or by national competent authorities. The issuance of covered bonds is an ordinary funding tool and, as such, should be within the full control of the prudent management of the issuing entity.

In this respect, a prior and/or post notification to the supervisory authority – in order to keep the supervisor update with the funding plan of the bank would be advisable.

For the purpose of the above, a programme could be defined as a programme of issuance having common main terms and conditions backed by a single pool of assets.

3. Should the Framework explicitly allow the use of SPVs to ring-fence cover pools of assets backing issues of covered bonds? What specific requirements should apply to these SPVs?

The EBF considers it very important that the European Commission recognises that the three most common covered bond models used in Europe (specialist issuer, direct on-balance sheet and direct with SPV guarantee) each have their own raison d'être. Therefore, the use of SPVs holding cover pools should be allowed where the legislator finds them appropriate to guarantee the ring-fencing of the cover pool which is valid, also post-insolvency, of the issuing bank.

Furthermore, where the holder of the cover pool assets is a legal entity, which differs from the originator and/or covered bond issuer, it must be safeguarded that the transfer of these assets to the holder of the cover pool is legally valid, binding and enforceable.

The EBF further agrees that an explicit permission of the corresponding regime applicable could in fact contribute to the use of SPVs. However, in cases where SPVs are not expressly provided for by the European Commission, it is essential that any adopted framework does not restrict the use of such SPVs as they are an important tool in many countries to ensure double recourse and asset segregation.



On the other hand, given that the legal structures and, consequently, the necessary legal rules, are different depending on whether the pool of assets remains in the balance sheet of the originating bank or is transferred to another legal entity, we find it important that this difference is duly taken into account in the structure of a possible new directive and that conceptual clarity is ensured, including in relation to securitization.

4. Regarding the use of pooled covered bonds structures and SPVs:

a) would it be desirable for an EU covered Bond Framework to allow the use of these structures and why? What legal structures are used in your jurisdiction to pool assets from different lenders or issuers?

b) which approach would be the most suitable for pooling assets across borders?

c) where the issuer of pooled covered bonds is an SPV, should this issuer be regulated as a credit institution or as some other form of legal entity?

- (a) Yes, the use of pooled covered bonds structures could be positive for the EU covered bond framework in order to allow also pool of small banks to accede the Covered Bonds market. In addition to the mere recognition, the Framework should positively encourage the pool structures by removing regulatory obstacles to the implementation of such structures.
- (b) The most suitable approach for pooling assets could be through an SPV, which would purchase such assets from the different originators.
- (c) The issuer of pooled covered bonds should be a licensed bank or an SPV, which would benefit of a guarantee on the bonds issued by it.

QUESTIONS – ON-GOING SUPERVISION AND MONITORING OF COVER POOLS (PRE-INSOLVENCY)

1. In your view, would it be desirable for an EU covered bond Framework to set common duties and powers on competent authorities for the supervision of covered bond programmes and issuers? What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?

It would be desirable for National Frameworks within the EU to specify the duties and powers of the competent authority as recommended in the EBA report. This could apply at common principles level and could promote consistent practice and supervision by competent authorities within national frameworks. Areas to be considered might include role of cover asset monitor, mechanisms to oversee cover pool asset inclusion / withdrawal from cover pools, valuation mechanisms, powers of the manager / administrator in the event of issuer insolvency.

2. What are your views on the proposals set out in subsection 2.2 of Part III on the appointment of and legal regime for cover pool monitors?

The EBF is supportive of the European Commission's proposals for a regime for cover pool monitors. EBF members have expressed a positive interest for such a regime, but stressed that given the particularities of each national covered bond model, more precise recommendations than those introduced in the Consultation Document would be difficult to agree upon as requirements of duties and powers depend on the national covered bond model. Furthermore the EBF share the EBA recommendation that the appointment of a cover pool monitor is not necessary if the similar tasks of such monitor are carried out by the competent authority.

Other issues which have been highlighted as important with regards to supervisory practices are:



- The cover pool monitor should be appointed by the issuer, but should meet independency requirements
- The cover pool monitor should be an auditing firm or other qualified professional company
- The cover pool monitor should perform pool audit and verify compliance with coverage tests and to the art 129 CRR. The review should be made on the basis of appropriate “agreed upon procedures”
- There is no need for a passporting mechanism if the cover pool monitors are selected among auditing companies.

QUESTION – COVERED BONDS AND THE SSM

Should the ECB have specific supervisory powers, and if so which ones, in relation to covered bond issuance of credit institutions falling within the scope of the SSM?

Specific supervisory powers in respect of issuers in SSM jurisdictions would likely lead to a division in the EU covered bond market as between issuers in SSM jurisdictions and issuers in non-SSM jurisdictions. This would appear to be at odds with the goal of market convergence.

Within the framework of Option 1, a single competent authority in each jurisdiction would be appropriate.

QUESTION – DUAL RECOURSE PRINCIPLE

Do you agree with the proposed formulation for “dual recourse”?

The EBF agrees with the proposed formulation, subject to what is indicated below:

- The definition include a concept of “absolute priority”. However, the framework should allow that the CB payments are subordinated to transaction providers’ costs in relation to the cover pool.
- The definition defines “full recourse” as the entitlement to the proceeds of the liquidation as “unsecured creditor” for any deficit that may result from applying the proceeds of the cover pool. The requirement should be also satisfied in case the bondholders (or the SPV on their behalf) have the right to the proceeds as “unsecured creditor” for an amount equal to the nominal amount of the bonds (and subject to the obligation to pay back to the bankruptcy estate any amount in excess collected in connection with the liquidation of the portfolio).
- As national insolvency regimes are not likely to be harmonized in any foreseeable future, we propose the definition to be clarified as follows: “The issuer’s default may be triggered upon its resolution or insolvency in accordance with the applicable national law.
- In our view, the use of a SPV in certain EU countries and the use of a cover register providing legal basis for asset segregation in case of issuer insolvency in some other EU countries should be treated equally (if they both safeguard asset segregation according to national legal specifics). While a generally notification requirement of borrowers seems overdone, in case borrowers lose their set-off right once the loan is part of a covered bond pool, they should probably be notified.

QUESTIONS – SEGREGATION OF THE COVER ASSETS

1. Are there any advantages to using an SPV as an additional segregation mechanism at issuance? Are cover assets typically transferred to the SPV at issuance via legal or equitable assignment?

The EBF would encourage the EU authorities as regard each existing model/method (i.e. use of an SPV or reliance on statutory provisions) as a robust option for approaching asset segregation rather than pitching the options against one another.



Operational procedures should be clarified under each model so that the priority claims over the cover pool are as clear as for SPV structures, while ensuring the protection of all assets (primary, substitution, hedging derivatives) as suggested by the European Commission. We believe that a “best practice” approach would be better here in order to take into account all the legal specificities of the different countries and issuers. Guidelines to mitigate set-off and/or commingling risks could be useful as well.

The use of SPVs, within the covered bond framework, has proven to be a successful means of asset segregation, as well as other types of asset segregation used in other jurisdictions. Using an SPV as an additional segregation mechanism has advantages as well as disadvantages (more complexity, assignment risk, transfer pricing) and the future legal framework should give a fair treatment to both alternatives.

2. In your jurisdiction, what legal and practical steps are required in order to segregate effectively the cover assets from the issuer's insolvent estate or in resolution? Would it be necessary to serve a notification to each borrower of the issuer? Until notification is served, what is the legal status of any proceeds of the cover assets which may be paid directly into the insolvent estate or to the issuer in resolution?

Currently 10 countries provided an answer to this question:

1. Under the **Irish** framework all cover assets are held within a specialist legal entity – a designated credit institution whose activities are restricted within the context of being a covered bond issuer. Preferred Creditors (bondholders, hedge counterparties, cover asset monitor or manager) have preferred claim over cover assets and their proceeds. The claims and rights of preferred creditors are not affected by the insolvency of a designated credit institution or its parent.
2. Under the **Portuguese** jurisdiction, the assets (mortgages loans or public sector loans and substitute assets) and derivative contracts assigned to a covered bond programme are held by the issuer in separated accounts – cover register – and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key. The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default.

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the covered bondholders.

In an insolvency situation of the issuer two situations may occur:

- a) The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;
- b) The revocation of the authorisation of the issuer with outstanding covered bonds or public sector covered bonds takes place, and the Bank of Portugal shall appoint a credit institution⁷ to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the covered bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all

modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law No. 59/2006.

3. Under the **Finnish** law the cover pool is legally segregated from other assets of the issuing institution when the covered bonds are registered at issuance in the covered bond register required by law to be held by the issuing credit institution and supervised by the competent authority. This constitutes a dual recourse right to the bondholder in accordance with the general insolvency law. We would advise against any additional harmonised rules in this respect as it would only add to the complexity of the legal framework in which we see no need for revision.
4. As for the **Luxembourg's** jurisdiction: In case of a bankruptcy of a covered bond bank the assets and derivatives products registered in the cover pools are separated from the other assets and liabilities of the bank, whereby each category of cover pool forms a special estate (compartments patrimoniaux). The special estates will be run and managed as a covered bond bank with limited business activity by a qualified trustee, appointed by the responsible insolvency court. As the covered bond bank with limited business activity remains solvent and continues the covered bond business in respect to the outstanding Lettres de Gages, it is bound to the legal regulations and reporting requirements for covered bond banks and subject to banking supervision by CSSF. The management of the special estates by the trustee is furthermore carried out independently and solely in the interest of the covered bond holders. The trustee is empowered to issue new covered bonds for the account of the covered bond bank with limited business activity, dedicated to the relevant cover pool category, and to engage in open market operations carried out by the European Central Bank.
5. Generally speaking, in order to fully segregate the assets from the issuer's capital, under the **Italian** framework, the issuer is required to register the sale of receivables identified by means of common criteria with Companies' Register and to publish a notice of the assignment in the Official Gazette. The registration of the sale of the receivables in the Companies' Register and the publication of the notice of the assignment in the Official Gazette are necessary in order to render the assignment enforceable against the debtor. Even if this is not necessary to make the assignment effective against the debtor, seller is also obliged to give notice to the debtor of the assignment as soon as possible.
6. Under the Danish framework for specialized mortgage banks all assets are assigned to specific cover pools, referred to as Capital Centers in Danish law. Each Capital Centre must comply with minimum capital requirements implied by the CRR. Assets may be transferred from one Capital Centre to the other insofar as the Capital Centre is solvent. If the transfer would lead to insolvency transfer is prohibited by law. Further, if insolvency procedures have been initiated transfer of assets between Capital Centers is prohibited in general. Furthermore it will not be necessary to serve a notification to each borrower of the issuer because there's no commingling risk due to the narrow business area for the Danish mortgage banks (non-deposit taking and only funding loans with covered bonds). However, the resolution authority or the liquidator in insolvency would, most likely, inform the borrowers to continue the payments. Also since there is no commingling risk, the proceeds will be distributed to each cover pool (Capital Centre). It should be noted that every Danish mortgage bank has several cover pools (Capital Centres) due to the long term issuance of covered bonds and product developments.
7. In Norway all cover assets are held within a single purpose vehicle – the covered bond issuer. The designated credit institution's activities are restricted according to law, in the context of being a covered bond issuer. Preferred creditors (bondholders and derivative counterparties) have preferred claim over cover assets and their proceeds. The claims and rights of preferred creditors are not affected by the insolvency of a designated credit institution or its parent.
8. Under the Spanish jurisdiction, the assets assigned to a covered bond programme are recorded in a special and well regulated internal register. Inclusion of assets in that register does not convey the obligation to notify borrowers, according to Spanish Civil Law (the assignment of loans/credits does not need to be notified to debtors).

9. The main challenge underlying the asset segregation process consists of an efficient and bankruptcy-remote full transfer of the mortgage collateral. For covered bond models where the cover assets remain on the balance sheet of the issuing institution, their identification is ensured through a registration in a cover register, like it is done in Germany and many other countries. In **Germany**, the segregation of the cover pools happens ipso jure with the appointment of a cover pool administrator. All assets registered at that moment in the cover register would form the “Pfandbrief bank with limited business activity”. No notification to the debtor of the cover asset loan is required. The Pfandbrief bank with limited business activity is not a new legal unit but an estate within the existing bank which now would comprise of two estates: the insolvency estate and the Pfandbrief bank with limited business activity. All proceeds from the cover assets received by the bank since the appointment of the cover pool administrator would be part of the Pfandbrief bank with limited business activity. This legal segregation then would be followed by a practical separation of bank accounts, staff, resources etc which the insolvency administrator and the cover pool monitor would undertake over time. Until that, all proceeds would have to be separated on the accounts on a permanent base.

10. The detailed procedure, regulating the mortgage bank’s insolvency has been described in Article 442-450 of the **Polish** Bankruptcy and Reorganization Law (in force since 01/01/2016). It assumes, among other things: the creation of separate bankruptcy pool, addressing the claims of CBs holders; the bankruptcy proceedings are conducted under the supervision of the court, with the participation of the curator representing the interests of CB holders; an extension of 12 months (since the date of bankruptcy) of the maturity of mortgage bank’s liabilities against CB holders, performing a coverage balance test and a liquidity test (the first to check if the liabilities included in the CB register are sufficient to fully cover the claims of CB holders, the second – to check if those liabilities are sufficient to satisfy the investors if the CBs’ maturity is extended).

QUESTIONS – LEGAL FORM AND SUPERVISION OF THE COVER POOL

1. Should the cover pool be incorporated as a regulated entity? In that case, what type?

This question affects the fundamental legal structures of a covered bond model. We can differentiate five covered bond models, all of them having advantages and disadvantages: fully specialised issuer, largely specialised issuer, non-specialised issuer, issuer with separate cover pool SPV and pooling of cover assets. It would be useful to establish at EU level a high level set of regulatory requirements for the cover pool/SPV which Member States could implement in national legislation as part of the other national legislative covered bond requirements. The SPV/cover pool should obtain a specific licence on the basis of such covered bond legislation as part of the approval process applicable to the covered bond programme and issuer under such covered bond programme.

In cases of insolvency/resolution of the issuer, the cover pool should be administered as a separate entity but this entity does not have to be a “new” legal person.

2. Who should be the supervisory authority for these purposes, the competent authority or the resolution authority?

See answer to previous question.

QUESTIONS – SPECIAL ADMINISTRATOR OF THE COVER POOL

1. What are your views on the proposals set out in subsection 3.3 of Part III on the appointment and legal regime for a cover pool special administrator?



We do not see a need for additional administrative functions. It is adequate that on going concern basis the compliance with applicable regulatory requirements is supervised by the competent authority. On gone concern basis the cover pool should be administered primarily by either the resolution authority in accordance with the existing resolution regime or by a liquidator in accordance with national insolvency law and current powers and responsibilities should not be interfered with. This should not prevent the appointment of a separate person to guard the interests of the bondholders but such a person should not be given the powers to carry out any transactions but only have access to information and the right to report to the relevant authorities. Otherwise the division of responsibilities between the persons involved might get muddled and in any case such a system would add unnecessary complexity to the legal framework. In particular, courts should not be involved beyond the national general insolvency legislation, given the existing differences between Member States in this respect.

2. Should the special administrator be obliged to report regularly to the relevant supervisory authority? Should the content and regulatory of such reporting be the same as for the issuer?

The special administrator clearly ought to report to the relevant supervisory authority. The contents and the regulation of such reporting should be similar to the one legislations foresee for issuer's administrators, but perhaps a little more intense due to the importance of an orderly and adequate management of the cover pool once the issuer enters into bankruptcy /insolvency.

QUESTIONS – RANKING OF COVER POOL LIABILITIES

1. Do you agree with the suggested ranking for cover pool liabilities? Is the wording proposed in subsection 3.3 of Part III sufficient to define clearly the claims that may arise, avoid confusion between claims and prevent claims in an unreasonable amount from arising?

Yes, we agree with the ranking. It may, however, be difficult to produce a detailed closed list of administrative claims to be covered. Instead, we suggest that the principle is expressed in a principle-based manner for instance as follows: Administrative expenses arising from the liquidation of the covered pool shall be deducted before the claims of the bondholders are met.

2. Is it possible to define hedging activity better and, if so, how?

We do not see the need to precise more the definition of hedging since it is a reality well known by the financial world and any attempt of defining it could risk to be partial and exclusive.

QUESTIONS – INTERACTION BETWEEN COVER POOL AND ISSUER IN INSOLVENCY/RESOLUTION

1. Are current provisions in EU law sufficient to deliver effective protection for bondholders in a resolution scenario involving covered bonds? In particular, is it sufficiently clear:

a) how the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?

b) how the full recourse against the issuer would take effect if the issuer is in resolution and is not placed subsequently into liquidation?

c) what procedural steps should be followed in resolution and by whom in order to make effective the dual recourse mechanism?



- (a) The Resolution Directive currently does not regulate covered bonds sufficiently. On the one hand, the current EU law does not provide for any effective protection for cover pool and covered bondholders. Only art. 52 IV UCITS requests a kind of segregation, but leaves unregulated what level of segregation should be achieved and in what way. The BRRD refers expressly to covered bonds, but does not treat in a comprehensive manner the point of the segregation. Given the segregation of the cover pool in the SPV, as provided in the domestic legislation, it has to be considered that the resolution tools and powers under the BRRD are not applicable in respect of the cover pool.
- (b) Yes. Bondholders rank *pari passu* amongst themselves as unsecured creditors in respect of any shortfall following exhaustion of the cover pool and would have a claim against the institution in resolution for recovery of the debt.
- (c) Under certain national legislations, covered bondholders benefit from two different claims: one against the cover pool segregated in the SPV, and the other against the issuer. We understand that the full recourse against the issuer might be impaired to the extent that the liabilities would exceed the foreclosed value of the cover assets, as on the exceeding amount the BRRD resolution tools may be applied. The Framework should ensure that – until the covered bonds are repaid in full – the bondholders should have a recourse to the general assets of the issuer for any amount not repaid through the liquidation of the cover pool. In this respect, the Italian legislation may provide a guidance (at least for covered bonds carried out segregating the cover pool in a vehicle). Indeed, according to these legislative framework, in case of liquidation of the issuing bank, the guarantor makes the payment under the covered bonds on the basis of the original timeline and exercise on an exclusive basis the rights of the noteholders *vis-à-vis* the issuing bank. Therefore, the guarantor would have the right to apply for the amount already paid by it under the guarantee and for the amount not yet paid (but that it will be paid) under the guarantee in the future. In case the sum of (a) the proceeds of the cover pool and (b) the amounts paid by the issuing bank to the guarantor, exceed the amount due under the covered bonds, any excess would be paid back to the issuing bank. The same mechanism applies in case of temporary suspension of the payment obligation of the issuing bank.
- (d) In order to have effective the full recourse mechanism, the resolution plan of each institution should deal with the existence of covered bonds programme.

2. Should the Framework provide for a cut-off mechanism as suggested in subsection 3.4 of Part III? In particular, should such a cut-off mechanism:

a) preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified?

b) set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation?

c) extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bondholders at the outset of the resolution or insolvency proceedings?

d) give specific powers and duties to the resolution authority and, if so, what should those consist in?



1. Do you agree with the proposed definitions for "residential" and commercial loans" as cover assets? Should certain riskier residential or commercial loans (ie buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?

- (a) Yes we agree in essence with the definition but considering the following:
- a. Not only first ranking mortgage, but also lower ranking mortgages should be allowed, provided that loan to value limits are observed;
 - b. LTV could be calculated as the aggregated loan balance of mortgages, on the same property and included in the cover pool, divided by the latest property valuation undertaken by an "approved" appraisal company (e.g., approved by local banking or capital market regulator).
- (b) Riskier loans should be allowed in cover pools for the following reasons:
- (i) not allowing certain assets that are currently eligible in cover pools will have a detrimental impact on the ability for banks to provide finance to the real economy;
 - (ii) rating agency analysis will capture the impact of "riskier" loans by requiring higher OC and/or lower rating;
 - (iii) given the differing mortgage markets, defining riskier loans will be very difficult to achieve and the definition will evolve over time; and
 - (iv) excluding certain loans could lead to unintended consequences i.e. excluding certain types of loans that are currently deemed risky could create a concentration of lending in another category of loans that are deemed not risky – this could lead to a bubble in the previously perceived non-risky category.

2. In relation to mortgage loans:

a) what are your views on the proposed requirements on "perfection of security" and "first ranking mortgage"? Is registration of the security a requirement for perfection in your jurisdiction?

b) is the enforceability of mortgages in the different Member States equivalent or should there be additional requirements to ensure their equivalence?

c) are minimum standards for mortgage rights in third countries necessary?

- (a) Current legal process and registration of security allow for perfection of security (by this we understand an effective mortgage in favour of the lender). As stated above, we see no reason to exclude lower ranking mortgages (i.e., greater than first). In certain national framework, Central Banks prudential regulation requires that eligible mortgage loans must provide for a mortgage being duly registered; with reference to "first ranking", the Framework should allow (i) "economic first ranking" to be included in the cover pool. In particular, to the extent that any prior ranking secures an extinguished mortgage or a mortgage securing a limited amount, this should be taken into consideration for the purpose of LTV eligibility requirements, but it should not affect per se the possibility to have such loans in the cover pool; and (ii) any subsequent ranking. In addition regulation should ensure that also third parties mortgageors are not excluded from such definition.
- (b) In our opinion there is no specific need for providing additional requirements to ensure equivalence for the enforceability of mortgages, provided that this refers to a general concept of national laws within EU;
- (c) Yes, in principle and shall be at least equivalent to EU standards.



3. In relation to LTVs:

a) what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?

b) in the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed?

Could loan-to-income requirements be used to replace or complement LTV limits?

c) should there be an additional average LTV eligibility limit at portfolio level?

d) with the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?

e) should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?

(a) The EBF broadly agrees with the proposal except for LTV determining eligibility of individual loans, otherwise known as ‘Hard’ LTV limits. Applying ‘Hard’ LTV limits (where a loan above a certain LTV will result in the loan being fully ineligible for inclusion in the pool) at inception or an on-going basis will significantly reduce the availability of long term funding to credit institutions (with knock-on impacts to the supply of credit to the real economy). It will also expose covered bond issuers to very significant liquidity risks (i.e. loans becoming fully ineligible) thereby further exacerbating the impact of an economic downturn. ‘Soft’ LTV (where a loan above a certain LTV will still be eligible for inclusion in the pool but will have a discounted value when calculating OC), provided pool collateral is subject to regular revaluation, strikes the balance between protecting investors against declining asset prices and not creating liquidity risk for covered pools that result from ‘Hard’ LTV. Further detail provided in section e) below

‘The application of maximum LTV parameters to determine the amount of collateral which can contribute to the coverage requirements for programme liabilities is both sensible and well established in most European covered bond frameworks (‘Soft’ LTV limits / Irish ACS ‘Prudent Market Value’ concept). The on-going monitoring of these parameters against revised collateral valuations, together with legislative minimum OC levels, provides the conservative coverage required for bond investors.

Applying ‘Hard’ LTV limits in addition to an on-going ‘Soft’ LTV limit requirement would be crude, unwelcome and unnecessary. Market practice in relation to residential mortgage LTV at origination differs among European jurisdictions. Well designed ‘Soft’ LTV / Prudent Market Valuation rules can apply a balanced and consistent coverage measure across jurisdictions. ‘Hard’ LTV limits, even if applied only at origination, will not provide that balance and would give rise to unnecessary exclusion of collateral from cover pools based on market practice or loan seasoning.’

We also agree on the distinction between residential and commercial loans to set different LTV limits. We agree that LTV limits could be used for the calculation of collateralisation level. In case an LTV limit is set also as eligibility criterium (even if we do not share this solution), this should be limited to the date of transfer; subsequent changes to the LTV limits should not affect inclusion in the cover pool, but they should affect the calculations of collateralisation. It is not clear what the paper means for “recognition of privilege for any excess over LTV cap”. If this is referred to LTV at cover pool level, it is clear that all the proceeds (including the proceeds in excess of LTV level) would be used to repay covered bondholders in priority to other creditors (up to the covered bond nominal amount); to the contrary, if this is referred to individual



LTV limits, the privilege could not be considered, since any excess on the loan secured would be paid back to the mortgagor/debtor.

In line with the EC's proposal, more conservative LTV limits for commercial mortgage loans and regularly updated LTV levels (or the use of a long term LTV mortgage lending value) seem appropriate. However, in our view, differences in the recognition of LTV limits regarding OC calculation or if the part of the loan above the LTV is recognised as cover pool asset should be allowed to continue to co-exist, at least in the short term.

- (b) Standards should be simple, with commonly accepted principles and little or no exceptions. Insurance should be compulsory. There should be a single maximum LTV per asset class, with no exceptions or allowances. Higher LTV should be allowed in respect of insured properties, in respect of which an umbrella policy for the risk of default could be considered. Overall we do not think that loan-to-income requirements should be used to replace/complement LTV limits.
- (c) The EBF believes this would constitute an unnecessary constraint with little value-added.
- (d) The concept of allowing for a collateral value of less than the current market value has merit. However harmonisation in this area should be simple and pragmatic and not give rise to unnecessary complexity. We agree since the implementation of these standards could generate relevant issues both in the step-in phase and in the managing of the pool of assets' already assigned.
- (e) The LTV limits should be used to determine contribution to coverage. LTV limits should not apply as eligibility criteria (loan in-loan out) at inception. In addition, the application of LTV limits as eligibility criteria (loan in-loan out) on an ongoing basis could be really disruptive. On an ongoing basis, the only reasonable solution is to adapt calculation on contributions to ongoing LTVs.

In addition we see an issue in obliging issuers to replace NPL assets. In our experience, NPL should remain in the cover pools provided that the general coverage requirements are met. In other terms the ponderation of NPL should be zero in the performance of the periodic asset coverage or similar tests on the programmes. In such a way keeping the NPL inside or excluding them from the cover pool is neutral in terms of test at a certain date. Another reason for keeping NPL inside the cover pools would be a factor of continuity on historical statistics.

4. In relation to the valuation of cover assets:

a) how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?

b) what criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?

- (a) The value of covered assets should be updated at least on an annual basis, by means of updating the initial evaluation.
- (b) Accepted valuation standards within the relevant jurisdiction should apply

5. Should the Framework adopt the definition of "non-performing exposures" as set out in the EBA's draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-performing Exposures?

A common definition of "non-performing exposures" must be framed in concrete terms against which an exposure can be objectively assessed. The reference in limb (a) to materiality and in limb (b) to a debtor's being "assessed as



unlikely to pay” import a degree of subjectivity into the test. This could lead to numerous alternative interpretations which could on argument all prove correct.

We would propose the following revision of limb (a) as a definition of “non-performing exposures”:

“an exposure in respect of which one or more payments of principal or interest payable on that exposure are, under the terms of the security documents governing that exposure, more than 90 days past-due”.

We oppose a requirement for issuers to remove non-performing loans from the cover pool, in particular in relation to specialized mortgage banks for which the capital base form part of the cover pool. For these issuers the economic risk on non-performing loans has already been covered by provisions. A requirement to exclude non-performing loans from the cover pool would be double –counting the risk.

6. In light of the EBA's prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools, should the Framework exclude these assets completely from qualifying as cover assets (including, for these purposes, as substitution assets) or should they be allowed only subject to strict criteria and within the 10% limit currently permitted under Article 129 of the CRR? What is the added value and practical uses of RMBS/CMBS as collateral in your jurisdiction/issuer?

ABS inclusion in cover pool should be allowed only if compliant with terms established in 129 of CRR.

The practical use is that RMBS/CMBS could be used within a CB programme with pooling structures where assets are originated by different entities. In such a scheme each originator would retain the equity tranche of the securitisation, whereas the senior tranche would be part of the covered bond cover pool. In such a way the originator would retain the first loss of the securitisation and would be entitled to receive the excess spread of the portfolio after payments on the senior note.

Another use of such structure may be used by different banks of a same banking group, where one bank (supposedly the parent company) is the issuer of the covered bonds and other banks are originating their own portfolios, which will be securitised and the senior notes would be part of the cover pool of the covered bond programme. The same goals outlined above would be achieved.

The EBF also supports EBA’s conclusions concerning specific intra-group transfers of CRR-compliant covered bonds as eligible collateral, cf. footnote 106 in EBA’s report.

QUESTIONS – PUBLIC SECTOR LOANS

1. What are your views on the proposals for public sector loans as cover assets set out in subsection 4.1 of Part III?

Any EU-wide harmonisation in these areas could cause severe damages on a national level. The decisive question is what Member States - according to their national law - interpret as being part of the "public sector"? Given the (traditionally developed) national particularities, before discussing the harmonisation of quality requirements, a fundamental analysis should be made on how the national covered bond eligibility criteria for public debt are defined in detail.

The definition proposed by the Consultation Document is much more restrictive than the Article 129 (1)(a) CRR provisions, thus excluding all local government exposures which have been assigned a risk weight of 20%.

Moreover, the proposed title of the section, “public sector loans”, seems to indicate that only assets under a loan legal framework could be eligible, while bonds are also answering the proposed requirements. The term “public sector exposures” as defined in the CRR article 129 should be improved upon.

Additionally we would like to highlight that the proposals, while, similar to the existing, appear to change to the definition of a ‘Third country’ and may exclude some of the existing assets that are eligible.



Currently, for public credit assets in a defined third country to be eligible, they have to satisfy the legal definition of an eligible assets which includes the requirements of Art 129 of the CRR. While these will be maintained, it appears that an additional requirement will be introduced whereby a relevant third country will be required to have a covered bond framework / covered bond laws in force, equivalent to the EU covered bond Framework. This may exclude assets which would otherwise qualify under Art 129 to the CRR and if correct, we would not support.

In linking the quality of the supervisory regime to the eligibility of the asset, it appears eligibility/quality of an asset could become more subjective. Under the requirements as they stand it is much more definitive on what is / is not eligible.

Allowing issuances from other non EEA jurisdictions as eligible cover assets in an EEA coverpool could lead to the lack of clarity as to what the underlying collateral actually is.

2. What eligibility requirements in terms of validity and enforceability should apply to the guarantee granted by the relevant public sector entity?

The guarantee should be legally valid and enforceable against the issuer of the guarantee.

QUESTIONS – OTHER ASSET CLASSES: AIRCRAFT, SHIP AND SME LOANS

1. Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits? If so, what criteria and limits should be applied?

As a matter of simplicity and transparency we believe one cover pool should comprise essentially one single broad asset class (apart from other liquid assets subject to low % of cover pool).

We have therefore nothing fundamentally against programmes covered by pools of other assets classes, provided they are in separate programmes.

We also believe that for collateral types currently not benefiting from regulatory privileges, namely SME loans, other funding instruments, more suitable for the variety of SME loans across the EU, could also be considered.

2. In relation to SME loans, is it possible to identify a category of "prime" SME loans as a potential eligible asset class for cover pools?

It should be possible using regulator-approved bank internal ratings among other criteria. We also believe that SME portfolios should be as much granular as they can in order to avoid the risk concentration.

QUESTIONS – MIXED POOLS AND LIMITS ON EXPOSURES

1. Do you agree that mixed-asset cover pools should be allowed?

As a matter of simplicity one cover pool should comprise essentially one single broad asset class. By "asset class" it is meant credits fundamentally homogeneous from term or security perspective. Other liquid assets (e.g., cash, treasury bonds) would be allowed but only to a limited extent (e.g., maximum 20% of cover pool). Apart from simplicity this would afford proper risk allocation and thus more efficient pricing.

2. What are your views on the proposed limits on specific assets and concentration of exposures? Should any other limits or requirements apply?



We do not agree that a concentration limit on the exposures to credit institutions should be included. In ordinary Covered Bond programmes a concentration limit would create complications in the management and investment of the liquidity and this may drive to unwanted operational risks to be increased for the covered bondholders.

QUESTIONS – COVERAGE REQUIREMENT

1. Which option should be preferred for the Framework to formulate the coverage requirement and why?

a) a general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;

b) a nominal coverage;

c) a net-present value coverage;

d) a net-present value coverage under stress; or

e) any other or a combination of the some or all of the above.

Our preferred options are A, B and C.

In particular, as it concerns option c –

c) a net-present value coverage should be used. Soft LTV with regular indexation provides on-going protection against asset price declines within the pool. This regular indexation along with interest rate sensitivity tests and currency matching tests will provide sufficient protection against market moves.

We recognise the merits of stress testing but note that all stress tests should be consistent across all jurisdictions and recognise the differing historical pool performances to avoid disadvantaging particular countries. A country that has experienced recent economic stresses in relation to assets in its cover pools should not be subject to more stringent OC than countries which have experienced none or minimal economic stresses. In fact, one could argue that countries which have not experienced such stresses should be required to hold more OC given that their cover pools have not demonstrated their ability to survive severe market stresses.

2. If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines? If so, what specific stress tests should be required and why?

As outlined in Q1 we would not favour the introduction of net-present value coverage under stress.

We recognise the merits of stress testing but note that all stress tests should be consistent across all jurisdictions and recognise the differing historical pool performances to avoid disadvantaging particular countries. Introducing specific stresses applicable to any CB programme may pave the way to possible distortions. In general terms stresses may depend on the specific mortgage market (for instance stresses are on pre-payments, defaults and similar factors, which cannot be the same for every country, every market and for any point in time).

3. Should derivatives entered into in relation to the cover pool be taken into account for the purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?



The only purpose of derivatives in the cover pool is protection against interest rate and/or currency risk, rather than collateralising covered bonds. Therefore, derivatives represent neither “orderly” cover assets nor “substitution” assets. However, depending on market fluctuations of interest and forex rates, the net derivative exposure varies over time. The focus on derivatives should be to ensure all collateral posted is effectively segregated, but clearly identified as collateral posted for the benefit of cover pool derivatives. In addition, the frequency and methodology used to mark-to-market should be given careful consideration – the more frequent the process then the less risk in the cover pool and similarly the mark-to-market methodology should follow market standards for derivatives.

4. What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?

Where national frameworks allow a restricted amount of such assets and rules for their eligibility within the cover pool they should be taken into account to determine coverage ratios.

QUESTIONS – OVERCOLLATERALISATION

1. Should a quantitative mandatory minimum OC level be set in the Framework? If so, what should that level be and should it be the same for all types of covered bonds?

In our view the overcollateralization depends on a number of factors, (i.e. characteristics of the assets, mismatch between assets and liabilities), therefore each OC level is set according to specificities of the relevant CB programme. However, as there are huge discrepancies in the different jurisdictions (and on the rating level achievable), setting a minimum level for every EU CB programme (we believe not exceeding 2% in order to comply with the guidelines set in the EMIR framework) may be acceptable. Higher levels may lead to distortions as may be penalising for certain issuers/CB structures.

Anyway as highlighted by the EBA in its recommendation, a further analysis of the level is needed, as it depends on several factors e.g. the class of cover assets together with the chosen coverage principle (as it differs across various jurisdictions).

2. If a mandatory minimum OC level were set in the Framework, should there be exceptions to the requirement? (for example where the issuer applies a precise "match funding model" or where certain targeted liquidity and market risk mitigation measures are used – see subsection 4.3 of Part III)

A full exemption does not seem appropriate and the minimum should apply to all covered bonds. In addition, these innovative structures have never been tested in a stressed environment so it would be inappropriate to give derogation to any minimum OC requirements in the absence of empirical evidence that these bonds will outperform more traditional structures in severe circumstances such as insolvency. Besides that, in match funded models the refinancing/liquidity risk may be lower but credit risk and interest rate risk, for example, may still exist to some extent.

3. Should the Framework set a maximum level of permitted OC? If so, when and at what level?

No. Newly established issuers which establish cover pools will have large OC (infinite OC prior to the issuance of the first covered bond) for a period of time as they build up issuance capacity. Also existing cover pools facing large redemptions which they do not need to refinance in the short term could lead to large spikes in OC. Removing assets to manage to a maximum OC would be costly from both a financial and resource point of view.

4. Should the Framework provide for the treatment of voluntary OC in the event of insolvency/resolution of the issuer?



Yes – Whatever voluntary OC does exist (subject to point 3 above) should be dealt with in any framework to ensure that the cover asset pool, including voluntary OC, is subject to recourse by preferred creditors. The framework should only ensure that, once that the covered bonds are repaid, the assets (or the proceeds arising out of their liquidation) are returned back to the issuer.

QUESTIONS – MARKET AND LIQUIDITY RISKS

1. In your view, are OC levels adequate to mitigate market and liquidity risks in the absence of targeted measures such as those described in subsection 4.3 of Part III?

Yes. Current OC levels derive from analysis performed by issuers and rating agencies. In particular the latter include in their analysis stress scenarios on the portfolio, interest rates and underlying assets.

Additionally it has to be noted that there are other protections against market and liquidity risk than OC. These include limitations on the interest rate risk that a cover pool can run, interest rate cover tests and a 12 month maturity extension feature which allows for the maturity date of the bond to be extended by up to 12 months should there be insufficient funds to repay upcoming bond redemptions.

2. Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4,3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?

We believe that prohibiting intra-group hedging and/or limiting the eligibility of derivatives' counterparties will have a detrimental impact on cover bond markets. External hedges will be expensive and very difficult if not impossible to execute, especially if eligibility is defined very narrowly resulting in a small number of eligible counterparts operating in this market. In all likelihood cover pools will not be able to hedge or only partially hedge interest rate and currency risk which will result in higher OC requirement by rating agencies (to maintain existing ratings) and/or lower rating of covered bonds. Increased encumbrance and/or lower rating bonds runs contrary to the aim of an integrated EU covered bond framework.

Restriction on the use of derivatives for risk management hedging only is sensible. Restriction on eligibility of counterparties is problematic and unnecessary. In particular the suggestion for prohibition of intra-group hedging should be opposed.

3. What are your views on the potential provisions on the management of cashflow mismatches suggested in subsection 4.3 of Part III? In particular:

a) for issuers, do cashflow mismatches between cover assets and covered bonds arise in your jurisdiction and/or transactions, and, if so, in which way? Are you able to describe a scenario for the timely repayment of the covered bonds? Do you plan for contingencies? Are such scenarios and contingencies disclosed to investors?

b) for investors, do you understand how such cashflow mismatches would be dealt with in practice? Would it be beneficial from your perspective to get systematic information about cashflow mismatches and how these would be managed?

Yes, cashflow mismatches do occur in cover pools and hence the ratings of covered bonds are sensitive to the credit rating of the issuer (dual recourse product) as distinct to a securitisation structure which only has recourse to the underlying pool of assets.



4. On the EBA's liquidity buffer recommendation:

a) should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool and, if so, in what circumstances?

b) should the buffer be calibrated to cover the cumulative net out-flows of the covered bond programme over a certain time frame? What length of time should be used as a time frame for calibration purposes?

c) what eligibility criteria should liquid/substitution assets meet to qualify for the purposes of this buffer?

(a) Some CB programmes already have certain liquidity buffers in order to cover interest flows and senior expenses over a certain timeframe. Such buffers are requested by rating agencies and tailored on the programme's characteristics. However we do not believe that a separate liquidity buffer/requirement is necessary for each covered pool. In our view, a liquidity requirement for the institution such as LCR is sufficient to ensure the liquidity in each individual pool. Moreover, any such requirement should be seen in the light of the balance principle, which is per se decisive to balanced cash flows, both for the individual cover pool and the institution as a whole. Thus, there is no need for any further regulation in this field other than the existing rules.

(b) Yes, one month should be sufficient time frame for calibration purposes.

(c) The appropriate criteria are those set out in Article 129(1)(c) CRR.

Both cash and sovereign bonds issued by EU Member States and EEA Member States should be allowed to be part of the buffer. Eligibility should be defined as somewhat broader than for the LCR.

QUESTIONS – TRANSPARENCY REQUIREMENTS

1. What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?

EBF members seem overall satisfied by the disclosures required under Article 129(7). It is submitted that current disclosure requirements are sufficiently comprehensive.

2. Should issuers disclose information on the counterparties involved in a covered bond programme and, if so, what type of information?

We believe that only public information on the counterparties should be disclosed.

3. How frequently should covered bond issuers be required to make disclosures to investors?

The EBF believes that disclosures on a quarterly basis is an adequate frequency.



4. What are your views on the existing and prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III? Would these templates:

a. be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA? and

b. be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?

The prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III are considered sufficient to carry out comprehensive risk analysis without further legislative backing. In addition its merit is to be cross-jurisdiction: therefore it make all CB comparable.

5. Should detailed disclosure requirements apply to all European covered bonds or only to those that would fall within the scope of the Prospectus regime?

A considerable part of the investor base prefers to invest in covered bonds issued in the form of private placements, which are not listed. As these bonds of a covered bond issuer are backed by the same cover pool as benchmark covered bonds from the issuer, disclosure requirements should apply to all European covered bonds. Only then will a comprehensive overview of the European covered bond market be possible. Nevertheless, the scope of disclosure must be balanced between precise requirements at European level and sufficient flexibility for national covered bond regimes.

6. Should the same level of disclosure standards apply pre- and post-insolvency/resolution of the issuer (except for those reporting items referring to the issuer itself)?

We believe that the same level of disclosure should apply pre- and post-insolvency.

7. In relation to covered bonds issued in third countries, what minimum level of disclosure should apply for European credit institutions investing in those instruments to benefit from preferential risk weights?

The third countries covered bonds should have at least the same level of disclosure requirements as the European ones

